

# Forced Combination of Corporate Tax Returns in North Carolina: A Multistate Perspective

Todd Lard

Vice President & General Counsel  
Council On State Taxation (COST)

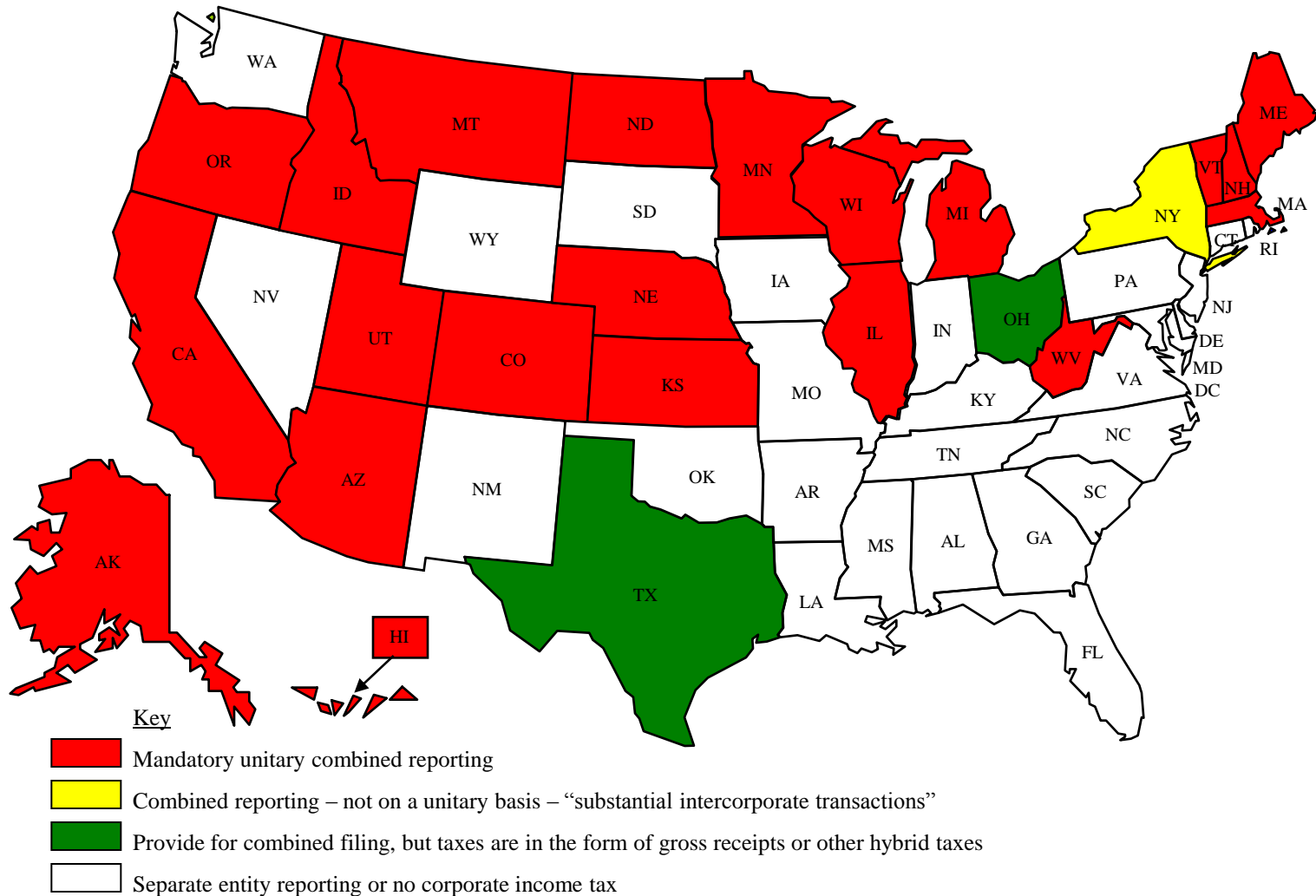
# North Carolina a Separate Entity Filing State

- Under NC corporate tax law, separate entities are required to file separate tax returns. GS 105-130.14, .16
- Majority of eastern states are separate entity filing states.

# Other States are Mandatory Unitary Filing Jurisdictions

- Majority of Western states require combined reporting of corporate affiliates which constitute a unitary business
- Not the same as federal group
- U.S. Constitution requires functional integration, centralization of management and economies of scale

# Mandatory Unitary Combined Reporting: 2011



# Elements of GS 105-130.6

- Elimination of payments "in excess of fair compensation in all intercompany transactions"
- If the Secretary "finds as a fact that a report does not disclose the true earnings of a corporation on its business carried on in this State"
- "The Secretary may require a return of the entire operations of the parent corporation and of its subsidiaries and affiliates"
- "The Secretary shall determine the true amount of net income earned by such corporation in this State"

# Use of GS 105-130.6

- Rarely used until after 2000
- Only one reported case construing GS 105-130.6 until the *Wal-Mart* decision in 2009
- No DOR regulations or directives
- Very rare for other states to use this type of provision

# Problems with GS 105-130.6

- "True earnings" not defined by statute
- "True earnings" not defined by case law, DOR reg or rule
- Relationship between first sentence requiring elimination of payments in excess of fair compensation and second sentence authorizing combination not clear in statute
  - did the Secretary first have to eliminate payments in excess of fair compensation before combination?
  - or could the Secretary combine without eliminating intercompany payments?
  - were excessive intercompany payments a threshold requirement to combination?
  - or could the Secretary force combination even if there were not excessive payments and transactions were at arms length

# Problems with GS 105-130.6 (cont.)

- If combination was forced, what was the appropriate group?
  - the entire unitary group
  - only those which had dealings with the taxpayer
  - or other portions of the group
  - and what would trigger the decision as to who was included in the group
- The statute provided for penalties if the combined return was not filed within 60 days after it was demanded.
- However, the DOR began to routinely impose stiff penalties even if the return was filed within 60 days.



# Events Provoking Use of Forced Combination

- Tax planning of 1980s and 1990s
  - Some tax planning lead to structures that lacked significant business purpose and substantial economic substance
- Recession of 2001 lead to falling state tax revenues.
- AG staff developed a theory on the use of the forced combination remedy as early as 1994.

# Forced Combination Escalation

- Decade of full employment for tax managers, CPAs, lawyers and lobbyists in the forced combination wars in North Carolina
- The wars were embittered by the refusal of the DOR to promulgate standards
  - "It has been suggested that the Department should issue some kind of guidelines as to when we will look to combine....If we list criteria by which the Department will determine to combine, taxpayers might argue that their activities do not meet those criteria and, therefore, combination is improper. If they were to meet the criteria but not like the result, they would just appeal the decision and argue that we have exceeded our authority or misinterpreted the law...We will not issue such guidance!" Norris Tolson, Speech to COST Conference in Charlotte, February 15, 2006
- One-way application and "cherry-picking"

# *Wal-Mart*

- The first casualty was the Wal-Mart Corporation which lost its tax battle with the DOR over the use of its REIT structure
- Trial court decision in 2008 affirmed assessment based on forced combination of Wal-Mart with several affiliates

# *Wal-Mart (Cont.)*

- The most significant casualty was GS 105-130.6, the forced combination statute itself
  - GS 105-130.6 imposed limits on combination – “true earnings” on business carried on in North Carolina
  - Rendered almost meaningless by the Court of Appeals decision in the appeal of Wal-Mart handed down in May, 2009
- “The essential meaning of the phrase ‘true earnings’ refers to the limit on state taxation found in the US Constitution”
- “...if the entire enterprise is a unitary business, true earnings may be calculated by apportioning the earnings of the entire enterprise on the basis of sales and other indicia of activity in the State.” 197 N.C. App. 30,\_\_\_\_ (2009)

# *Wal-Mart (Cont.)*

- BUT North Carolina is a separate entity filing state and not a unitary combined reporting state.
- The Court of Appeals did not reconcile its ruling with the law as enacted by the General Assembly.
- Although the Court discussed distortion, it failed to articulate a clear standard for determining when distortion would be such that forced combination was justified.
- Wal-Mart settled with the DOR, abandoning its appeal to the NC Supreme Court.
- Leaving taxpayers wondering the standard for forced combination.

# Resolution Initiative

- The next casualties of the forced combination war were taxpayers who felt compelled by the threat of severe penalties to settle with the DOR in the Resolution Initiative in 2009.
  - 130 corporations entered into combination agreements with the DOR under that program.

# Delhaize

- The only other reported case dealing with GS 105-130.6 is the Delhaize decision, Judge Tennille, January 12, 2011
  - The Business Court, required to follow the holding of the Court of Appeals in Wal-Mart
  - Upheld the combination assessment against Delhaize
  - struck the penalties imposed by the DOR.
- The Court found as a fact, ( the Department) “worked actively to conceal the standards its decision makers were using when exercising their authority to combine returns. The Department forced taxpayers to guess whether they would be subject to compelled combination and resulting penalties.” Para 58

# Delhaize (Cont.)

- Judge Tennille ruled that the penalties assessed were void as violative of procedural due process and the power of taxation clause of the NC Constitution
- He observed with regard to his due process ruling
  - DOR used penalties as a “club” “to coerce taxpayers into submitting to its will”
  - that decisions to impose the penalties "are made by a guarded coterie“
  - who apply "unpublished criteria“
  - and "who appear to revel in the criteria's mystery"
- The Department's penalty "has significant coercive power" which in these circumstances "violated due process"



# Delhaize (Cont.)

- With regard to the power of taxation clause, the judge observed
  - “assessing a punitive penalty when Delhaize followed the law is itself unjust and inequitable”
  - That Delhaize had followed the law in filing its separate entity return
  - Imposing a penalty when the corporation followed the law is an unjust and inequitable exercise of the power of taxation

# Delhaize (Cont.)

- Repeal of penalties
  - Judge Tennille also ruled that it would be unjust to impose a penalty on Delhaize when the penalty structure had been amended in 2010 to require the issuance of rules before penalties could be imposed.
- Finally, Judge Tennille ruled imposition of penalties was an abuse of discretion by Secretary and beyond his statutory authority.

# Legislative Progress

- SB 242 (2007)
  - New appeals process
- SB 897 (2010)
  - Limitation on penalties

# Legislative Progress

- HB 619 and SB 580 (2011)
  - Repeals 105-130.6 (after 1/1/2012)
  - Establishes Standards on Combination
    - Economic Substance and Business Purpose
    - Only include all unitary entities unless taxpayer consents to cherry-picking

# Prospects

- Periods After 2012
  - Greater certainty
  - Less controversy and litigation
  - More favorable perception by business community
- Open Periods
  - Continuing litigation and uncertainty as to liability
  - Lasting taint on perceptions